DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 00-0056 and 00-0057
State Gross Retail Tax
For the Tax Years 1994 through 1998

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ISSUE

I. Assessment of Sales Tax on Equipment Leased by Parent Corporation from Taxpayer Subsidiary Corporations.

Authority: Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); 45 IAC 1.1-2-10; 45 IAC 2.2-4-27.

Taxpayers protest the imposition of the state's gross retail (sales tax) on the transfer of construction equipment from taxpayers (two subsidiary corporations) to the parent corporation. Taxpayers maintain that the sales tax was paid at the time the equipment was purchased by subsidiary corporations from independent third parties and that no additional sales tax liability accrued at the time of the transfer of the equipment from the subsidiaries to the parent company.

STATEMENT OF FACTS

Taxpayers are two companies which purchase and then rent construction equipment. During the tax years at issue, taxpayers purchased certain construction equipment and then transferred the equipment to the parent company. The equipment was used exclusively by the parent corporation.

Neither taxpayer had any dealings with other equipment lessees or with the general public. Purportedly, all incidents of ownership were borne by parent company with the taxpayers consisting of "nothing more than a checkbook." According to taxpayers, their function, as subsidiary companies, was to "provide protection for leased equipment against creditors in the event that [parent company] encountered financial difficulties."

Majority shareholder owned 100% of parent company. Majority shareholder and his wife owned 100% of taxpayer subsidiary one. Majority shareholder and employee owned

100% of taxpayer subsidiary two. Both taxpayers originally paid sales tax on the initial purchase of the equipment.

DISCUSSION

I. Assessment of Sales Tax on Equipment Leased by Parent Corporation from Taxpayer Subsidiary Corporations.

The audit assessed both taxpayers for failure to collect sales tax on the rental of tangible personal property. The assessment was made under the authority of 45 IAC 2.2-4-27 which states in relevant part that "the gross receipts from renting or leasing tangible personal property are taxable." 45 IAC 2.2-4-27(a). The regulation further states that "[e]very person engaged in the business of the rental or leasing of tangible personal property, other than a public utility, shall be deemed to be a retail merchant in respect thereto and such rental or leasing transaction shall constitute a retail transaction subject to the state gross retail tax on the amount of the actual receipts from such rental or leasing." 45 IAC 2.2-4-27(b).

The audit determined that the two taxpayers and the parent company were each separate legal entities and that the substance of the equipment transactions indicated that the transactions were leases subject to the gross retail tax under 45 IAC 2.2-4-27. According to the audit, the essence of the equipment transactions was that parent company was the lessee, taxpayers as the subsidiary companies were lessors, and that the transactions between them were equipment leases subject to the sales tax.

Taxpayers counter with two distinct arguments. In the first argument, taxpayers state that the two subsidiary companies were "pass through" entities for all tax purposes. Taxpayers maintain that the purchase and subsequent transfer of the equipment to parent company were transparent, pass-through transactions, and that they correctly paid sales tax on the transfer value of the equipment at the time the equipment was initially purchased. According to the taxpayers, all incidents of ownership remained with parent company, that the two taxpayers consisted of "nothing more than a checkbook," that majority shareholder was the sole decision maker for all three entities, and that assessing sales taxes on the otherwise transparent equipment transfers would be inequitable.

In its second argument, taxpayers argue that the transactions between themselves and parent company were not leases but financing agreements. In effect, the taxpayers were selling the equipment to parent company and entering into agreements to finance the equipment's purchase. According to taxpayer, because the transactions were not leases but financing arrangements, parent company was "buying" the equipment and the tax was due at the beginning of the transactions.

Taxpayer's first argument is that the equipment leases were pass-through transactions between closely held entities to which no sales tax liability could equitably adhere. The formal lease agreement submitted by taxpayers establishes with some precision the parties' relationships, responsibilities, liabilities, and duties. Taxpayers have indicated that its lease form is identical for all transactions except for the amount of the lease payment. The lease agreement identifies the equipment to be leased, the amount of each lease payment, the term of the lease, and the taxpayers' available remedies in the event that the parent company should default on the agreement. The agreement specifies that parent company will maintain the equipment, pay all licensing fees, insure the equipment, and bear any and all risk of the equipment's loss, theft, or destruction. Parent company is permitted to use the equipment in its "normal and ordinary business activities" but that use is restricted to a four-state area. Taxpayers retain the right to assign their ownership interest in the equipment to a third-party. At the taxpayers' option, the taxpayers may require parent company to fasten labels on the equipment indicating that the equipment is owned by the taxpayers. Taxpayers requests that the Department look past the language of its densely written lease agreements and look to the "reality and substance" of its transactions.

Taxpayers are correct in their assertion that in determining tax consequences, the Department is required to look at "the substance rather than the form of the transaction." Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992). However, in asking the Department to ignore the realities of the parties' relationship and the nature of the transactions conducted between those parties, taxpayers ask too much from the Department. The three entities – taxpayers and parent company – were established with and continue to maintain separate legal identities. Although the three entities share a certain measurable degree of common ownership, that common ownership is not perfect because separate persons share in the ownership of each of the two subsidiary taxpayers. Taxpayers' assertion, that the parent company retains all indicia of the equipment's ownership, is erroneous. The parties' lease agreement clearly states that "[t]he Equipment shall at all times be the sole and exclusive property of [taxpayers], and . . . [parent company] shall have no right, title, or interest in or to the Equipment . . . ." Taxpayers may have been formed for the exclusive purpose of protecting the interests of parent company. However, having taken on the protections and advantages of the corporate structure, entered into transactions which meticulously distinguish and limit the parties' relationships, liabilities, and duties, taxpayers may not then avoid the consequences of their business relationships and transactions.

Taxpayer's secondary argument is that the lease transactions are capital leases. If, as taxpayers maintain, the equipment transactions were capital leases, a financing arrangement and not a lease is created and the sales tax is due on the purchase price at the beginning of the transaction.

45 IAC 1.1-2-10 establishes a standard for determining if a lease agreement "is a financing device for a sale of tangible personal property . . . ." Under that regulation, "The department will consider many factors in determining the intent of the parties, including the following:

(1) Whether the lease payments are to be applied to any equity to be acquired by the lessee.

(2) Whether the lessee will acquire title to the goods upon the lessor's receipt of a stated amount of payments under the contract.

(3) Whether the total lease payments for a relatively short period of use make up an inordinately large proportion of the total payments needed for the lessee to secure title.

(4) Whether the lease payments exceed the current fair rental value of like goods.

(5) Whether the lease contains an option to buy at a price nominal in comparison to the value of the property when the option may be exercised.

(6) Whether a part of the lease payments is designated or recognizable as interest or its equivalent. Id.

The audit determined that the equipment transactions between taxpayers and parent company were operating leases. As evidence of this, the audit determined that both taxpayers included a rent and royalty schedule on their federal tax return and that both taxpayers claimed a depreciation allowance for the equipment.

Taxpayer's lease agreements include a provision by which parent company may exercise an option to purchase the leased equipment during the term of the lease. Paragraph 14 of the lease agreement provides that "[parent company] shall have the option during the term of this lease and for a period of thirty (30) days thereafter to purchase all or any portion of the equipment described in schedule A . . . ." Under the option to purchase paragraph, the purchase price for the equipment was "established by Schedule A to this Lease." "By attaching a copy of the invoice of the original purchase price the parties were establishing the value of the equipment referred to in the second sentence of paragraph #17." Therefore, parent company could purchase the equipment at any time during the term of lease – or within 30 days after the conclusion of the lease – for what taxpayers originally paid for the equipment.

If parent company decided to exercise its option to purchase the equipment, parent company was entitled to a credit for the total value of the lease payments which parent company had previously paid to the taxpayers. The lease states that the value of the equipment "shall be reduced by a portion of the rental paid in respect of the purchased Equipment under this lease." That portion of the rental credited to the equipment lease "shall be equal to the total amount of rental payments made under this Lease . . . ." The option to purchase paragraph includes a formula for apportioning accrued rental payments when the particular lease covers more than one item of equipment and parent company decides to purchase only one of those items of equipment.

In the sample lease provided by taxpayers, the initial purchase for the equipment was $111,085, the lease payments were $5,100, and the lease ran for 60 months. If parent company simply made lease payments for the entire term of the lease, it would have paid taxpayers $306,000. Under the terms of the sample lease, at the end of 22 months, parent company would have paid $112,200 and would have been entitled to unilaterally exercise its option to purchase the equipment at no additional cost.

A comparison of the taxpayers' lease agreements with the standards set out in 45 IAC 1.1-2-10 leads to the conclusion that taxpayers' lease agreements are simply financing devices for the sale of construction equipment to parent company. Taxpayers' lease agreements provide a means by which the lease payments are effectively applied to the equity acquired by the parent company. 45 IAC 1.1-2-10(c)(1). The lease agreements provides a means by the "[parent company] will acquire title to the goods upon the [taxpayers'] receipt of a stated number of payments under the contract." 45 IAC 1.1-2-10(c)(2) "[T]he total lease payments for a relatively short period of use make up an inordinately large proportion of the total payments needed for the [parent company] to secure title." 45 IAC 1.1-2-10(c)(3) Under the terms of the parties' lease agreements, "the lease payments exceed the current fair rental value of the goods." 45 IAC 1.1-2-10(c)(4) In addition, the parties' "lease contains an option to buy at a price nominal in comparison to the value of the property when the option may be exercised." 45 IAC 1.1-2-10(c)(5). In effect, the taxpayers' lease agreements constitute a contractual means by which the parent company is able to purchase construction equipment – at the conclusion of a specified period of time for a specified number of payments – at no additional cost to itself.

Setting aside the issue of which of the parties is entitled to take the depreciation allowance for the construction equipment, it is apparent that taxpayers are not in the business of leasing construction equipment. Taxpayers are in the business of entering into financing arrangements which allow the parent company to purchase construction equipment. Accordingly, taxpayers are obligated to collect sales tax at the inception of the lease transactions.

FINDING

Taxpayers' protest is sustained.

DK/PE/MR – 012906